*As I see*

## THE TAX ADVANTAGES IN OWNING REAL ESTATE

Because of the depreciation allowances on income producing **real estate** the yield is more favorable than from most other types of **investments** producing an equal amount of before tax income.

The annual deduction for depreciation is allowed under the income tax provisions to permit the investor to recover his investment tax free over the supposed life of the property. Actually very few pieces of property have ever developed an economic life as short as that allowed on the depreciation schedule. The allowance on a new building varies from 40 to 50 years while practically all income properties 40 or 50 years old still show a considerable earning capacity.

Suppose you purchase income producing real estate for $25,000 allowing $5,000 for the land and $20,000 for the building. Only the building can be depreciated. If the building is not new you could probably estimate its remaining useful life at 25 years.

For sample purposes, we are using the "straight line" method of depreciation, reducing the cost of the building 4% each year spreading the $20,000 paid for the building over the 25 years of its estimated life. This works out to an annual depreciation allowance of $800 which can be deducted from your income before taxes.

|  |  | 50% Tax Bracket | 75% Tax Bracket |
|---|---|---|---|
| Income after expenses | $2,200 | $2,200 | $2,200 |
| Less depreciation | 800 |  |  |
| Taxable income | $1,400 |  |  |
| Less income tax |  | 700 | 1,050 |
| Income after taxes |  | $1,500 | $1,150 |
| Yield |  | (6.0%) | (4.6%) |

If the same amount of money were invested in bonds (other than certain tax exempts), they would have to yield a rate of 8.8% to produce the same before tax income. The net results would be something like this:

|                      | 50% Tax Bracket | 75% Tax Bracket |
|----------------------|-----------------|-----------------|
| Taxable income       | $2,200          | $2,200          |
| Less income tax      | 1,100           | 1,650           |
| Income after taxes   | $1,100          | $ 550           |
| Yield                | (4.4%)          | (2.2%)          |

In the above and following examples I assume the taxpayer to be in the 50% and 75% income tax brackets. If you are in a lower bracket, your savings will be less. If your income is higher, you will also gain more.

If the purchase were not paid in cash but financed with a mortgage the yield would be greater.

Assume you p u r c h a s e the same property paying 25% down and financing the 75% balance at 5% interest. You are still permitted to depreciate the full $20,000 value of the building even though your cash outlay is only $6,250. The depreciation allowance increases your yield after taxes in the first year. In the second and each succeeding year the interest d e d u c t i o n is less thereby slightly decreasing your net gain.

|                           |        | 50% Tax Bracket | 75% Tax Bracket |
|---------------------------|--------|-----------------|-----------------|
| Income after expenses but |        |                 |                 |
| before interest           | $2,200 |                 |                 |
| Interest at 5%            | 937    |                 |                 |
| Income after interest     | $1,263 | $1,263          | $1,263          |
| Depreciation              | 800    |                 |                 |
| Taxable income            | 463    |                 |                 |
| Less income tax           |        | 232             | 351             |
| Income after taxes        |        | $1,031          | $ 912           |
| Yield                     |        | (16.5%)         | (14.6%)         |

The income after taxes will not be take home pay because mortgage repayments reduce tax benefits. Mort gage payments are not tax deductable. But as long as depreciation is more than the amortization you will be getting a bigger after - tax return on your investment.

Assume amortization at $670 a year. To produce $2,200 this would require an income of $2,870. For example:

|                       |        | 50% Tax Bracket | 75% Tax Bracket |
|-----------------------|--------|-----------------|-----------------|
| Income before amorti- |        |                 |                 |
| zation                | $2,870 | $2,870          |                 |
| Amortization payment  |        | 670             |                 |
| Income before taxes   |        | $2,200          | $2,200          |
| Depreciation          | 800    |                 |                 |
| Taxable income        | $2,070 |                 |                 |
| Less income tax       |        | 1,035           | 1,552           |
| Income after taxes    |        | $1,165          | $ 648           |

To simplify the examples given we have used the straight line method of depreciation. However, there are three other generally accepted methods used in real estate transactions. They increase the depreciation allowance in the early years, tapering off as the years progress, thereby permitting the investor to recover his investment tax free at a faster rate.

The 200% declining balance method amounts to 200% of the straight line rate applied to the undepreciated balance of the property. In the examples used above the rate would be 8% (twice the 4% straight line rate).

For example, a new building costing $20,000 could be depreciated $1,600 the first year (8% of $20,000), $1,472 the second (8% of $18,400) and so on down the line.

The 150% declining balance method is computed in the same manner but can be used for old as well as new buildings.

The sum-of-the-digits method is the fastest method of depreciation and is best explained by an example.

Assume a 25 year life for the building. Add all the numerals between 1 and 25. The total is 325. To determine the first year's depreciation allowance take the number of the last year (25) divided by 325, times the cost of the building (25/325 x $20,000) or $1,538. The next year's depreciation allowance would be 24 divided by 325, times $20,000 or $1,476 and so on.

It is important to know that the 200% declining balance method and the sum-of-the-digits method can be applied to new buildings only. The fastest method of depreciation available to investors in old buildings is the 150% declining balance.

If the faster methods of depreciation are used, particularly during a period of rising real estate values, they enhance the opportunity for capital gains.

## CAPITAL GAINS

Real estate is a capital asset. The profit resulting from its sale, if held for a period longer than six months, is a capital gain with special tax benefits.

It is to the advantage of every investor, large or small, to seek capital gains rather than dividend or interest yielding investments. Interest and dividends are subject to full tax as ordinary income. Ordinary income tax rates can go as high as 91%. The maximum capital gains tax is 25%.

Because capital gain refers to a ceiling and not a rate, many taxpayers are below the maximum 25% rate. This is true for married individuals whose income, after deductions, is under $36,000; $24,000 if head of a household; and $18,000 if single.
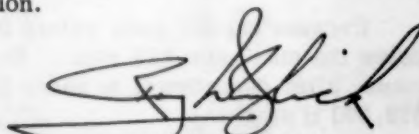
In computing the capital gains tax on a real estate sale, the following method should be observed:

Capital gain (or loss) is the difference between the selling price and the depreciated price of the real estate. For example, if a piece of real estate were purchased in 1946 for $25,000 ($5,000 land and $20,000 building) and depreciated at 4% a year, the annual depreciation allowance would be $800. Assume it was sold in June 1958 for the current market value of $37,365. The depreciated value (your book value) of the property would be $15,400 and your capital gain would be $21,965. Only 50% ($10,983) of this profit is reported as taxable. This 50% is taxed at regular income tax rates, varying with your income tax bracket but at a rate not exceeding 50%. The net result is a 25% tax on the original amount of the capital gain. Remember that the depreciation taken on the property over your 12 year period of ownership has been totally deducted from ordinary income and therefore was tax free.

| Purchase price, 1946 | $25,000 | Selling Price June 1958 | $37,365 |
|---|---|---|---|
| Less depreciation on building | 9,600 | Less depreciated value of building | 15,400 |
| | $15,400 | | $21,965 |
| | | Cap. gain | |
| | | Cap. gain tax at 25% | 5,491 |
| | | Net gain | $16,474 |

During your 12 year ownership you have received a cumulative income after tax of $18,000 if you were in the 50% tax bracket or $13,800 if you were in the 75% bracket. Add this to your net capital gain. The combined total is $34,474, or $30,274, respectively. Over the 12 year period you received an average yield of 11% or 10% on your investment, thereby doubling your money in 9 or 10 years.

Even on a residence occupied by the owner there is a tax advantage as the owner may deduct the amount of real estate taxes paid on the property from his gross income in figuring his income tax. A tenant can make no such deduction, although his rent includes taxes paid on the property. In looking over our last Tax Bulletin it would seem that the average savings in income taxes to an owner occupant on an average type dwelling would vary from slightly under $100 a year in low tax cities to slightly under $300 in high tax cities. If the accommodations occupied by the owner is of the luxury type, the tax saving may be a number of times as great as used in this illustration.

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